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ISRAEL'S CONTINUED ECONOMIC RECOVERY

¶1. Summary: On November 23, the Bank of Israel (BoI) announced a 0.25 percent increase in interest rates, bring the BoI rate to 1 percent in a move intended to return inflation to well within the target range yet low enough to support the continuing economic recovery. Preliminary third quarter economic data from the Central Bureau of Statistics indicates 2.2 percent growth, an increase in exports and a surge in imports. Even unemployment declined slightly in the third quarter, while labor participation remained basically unchanged. The BoI has continued to limit its intervention in the foreign exchange market and remains cautious about a monetary policy that would put additional downward pressure on the dollar. The OECD recently expressed its reservations about the BoI's previous interventions but has yet to comment on the BoI's more recent actions. These encouraging signs indicate that the recession was truly mild for Israel and that economic recovery is less tentative than first assumed. However, most commentators note that a fully global recovery is the surest sign of success for Israel's own. End summary.

¶2. The Central Bank intended to strike a balance between inflation considerations and supporting the economy's path of recovery in its decision to raise the interest rate by .25 percent. The target range for inflation is 1-3 percent, with Governor Stanley Fischer's ideal annual rate at the mid-point 2 percent. The inflation rate for the last 12 months was 2.9 percent, and but inflation rose 3.6 percent for the first 12 months of 2009. The BoI's press release accompanying the rate hike said the low interest rate of 1 percent continues the "accommodative monetary policy that is intended to support further economic recovery, ... as well as placing inflation firmly within the target range." The release also noted that inflation is expected to be above the upper limit of the target in the coming months, as 12-month forecasts increased slightly following the October CPI. Economic forecasters expect that the BoI will continue to increase interest rates by 0.5 percent over the next three months, gradually working up to 2.5 percent by the end of 2010 unless significant exchange rate or other macroeconomic changes occur.

¶3. In a recent meeting with Econoff, Dr. Karnit Flug, Head of Research at the Bank of Israel said that while economic results in the third quarter were good, the real question is sustainability. Following growth of 1 percent in the second quarter, real GDP growth is at 2.2 percent, while per capita GDP grew slightly by 0.3 percent after four quarters of negative readings. Exports were up more than 21 percent after increasing 15 percent in the second quarter, and imports grew by 61.9 percent. Private consumption was up by almost 9 percent and investment in fixed assets increased by over 23 percent. Unemployment was at least less bad, declining to 7.8 percent from 8 percent in the second quarter. This was the first decline in unemployment since the third quarter of 2008. Labor participation rates were

steady with the notable exception of Jerusalem, which usually has the lowest participation rates and among the highest poverty rates. Jerusalem's labor participation rate inched up 1. 9 percent in the first 10 months of 2009, which may indicate some early success of pilot projects to incorporate ultra-orthodox Jews into labor market.

¶4. The Bank's November 23 interest rate announcement noted that the dollar had strengthened against most currencies during the last month. In the period between the BoI's last monetary policy discussion and the November 23 rate hike, the shekel weakened against the dollar by 3.2 percent, by 2.2 percent against the euro and by 2. 9 percent against the basket of currencies. As the BoI policy is now to refrain as much as possible from forex intervention, they are cautious about monetary policy that might put downward pressure on the dollar. BoI contacts insist there is no dollar-shekel target exchange rate (the current shekel/dollar rate is about 3.8) and note the Governor's desire to move in the direction of infrequent to zero intervention in the forex market. In reference to the Bank's actions prior to September 2009, the OECD wrote in a November 19 announcement that the Bank of Israel's "continued foreign exchange interventions risk bringing additional inflationary pressures and damaging policy credibility and coherence." The monthly foreign exchange reserve report indicates that the Bank has in fact decreased USD purchases. In October, the Bank purchased USD 1.27 billion compared with USD 1.6 billion in September and USD 4 billion in August. The OECD is expected to release a final report in December that softens its criticisms of BoI actions in the forex market.

¶5. Following the rate increase, some commentators, such as Michael Sarel, focused on the significant increase in exports as the critical factor in pushing Fischer to raise rates. As long as the export situation improves, the Bank's concern about a strengthening shekel is diminished. Despite the increase, real short term rates remain very low, similar to levels in the U.S., U.K and Canada where the crisis was deeper and inflationary pressures more moderate. Sarel warns that inflationary pressures could become significant within the next year or two if rates remain so low. The rate increase also provided the pres an opportunity to praise Stanley Fischer's stewardship of the economy, citing local and international economists' assessments that Fischer's continued presence at the helm of the Bank is critical to Israel's continued economic recovery. If the figures speak for themselves, his continued tenure is his for the asking.

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